BEFORE THE

Federal Communications Commission

WASHINGTON, D. C.

In the Matter of Implementation of Section 19 of the Cable Television Consumer Protection and Competition Act of 1992 Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming	)	CS Docket No. 94-48

To: The Commission

REPLY COMMENTS OF HOME BOX OFFICE

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SUMMARY

In its assessment of competition and market performance, HBO suggests that the Commission apply a comparative institutional analysis as set out in the attached paper by Paul L. Joskow, professor of economics and management at MIT. Such an analysis asks what is the best outcome in the long run given the economic and regulatory attributes of the video programming and distribution markets.

HBO and a majority of commenters in this proceeding demonstrated in their initial comments that the state of competition in the video programming distribution industry is healthy and increasingly vigorous, and there is every indication that it will continue to thrive in the future. A few commenters, however, suggested that the market is not competitive based upon their individual experiences with certain programming vendors. The specific anecdotal complaints of these few commenters are not informative as to the Commission's inquiry into the state of competition in the distribution industry as a whole. The Commission has a complaint process to deal with alleged instances of discriminatory conduct by programming vendors. In any event, these complaints, at least as they pertain to HBO's practices, are incorrect.

With respect to future data collection by the Commission, HBO reiterates its position that the Commission lacks jurisdiction under the 1992 Cable Act to require periodic reports from programmers. In addition, HBO agrees with many of the commenters that suggest that the information the Commission seeks is already publicly available. To the extent the Commission believes it has

jurisdiction to require information from programmers, it should not require information pertaining to the rates charged by programmers to different types of distributors. This would essentially set the stage for rate regulation of programmers, which clearly exceeds the authority granted to the Commission by the Cable Act. Any information collection procedures must be designed to obtain information from programmers in a non-burdensome manner that ensures that confidential and proprietary business information is protected.

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REPLY COMMENTS OF HOME BOX OFFICE

Home Box Office, a Division of Time Warner Entertainment Company, L.P. ("HBO"), by its attorneys, hereby submits its reply comments in the above captioned proceeding.[1] In its initial comments in this proceeding, HBO demonstrated that competition among video distribution technologies is healthy and increasingly vigorous. For the most part, other commenters reached similar conclusions.

In these reply comments, HBO will first provide the Commission with an economic analytical framework to assist the

1 In the Matter of Implementation of Section 19 of the Cable Television Consumer Protection and Competition Act of 1992, Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, Notice of Inquiry, CS Docket No. 94-48, FCC 94-119 (rel. May 19, 1994) ("Notice").

Commission in assessing competition in the video programming distribution industry. In addition, a few parties raised issues in their initial comments regarding specific practices of HBO and other video programmers with respect to providing access to video programming. Although generally addressed elsewhere and, we submit, not relevant to the status of competition in the video programming distribution industry as a whole, HBO feels compelled to set the record straight with respect to its practices in these reply comments. Finally, HBO will set forth its views with respect to future data collection requirements for the Commission's annual report to Congress.

I. COMPETITION IN THE VIDEO PROGRAMMING DISTRIBUTION MARKET

A. Economic Methodologies for Analyzing Competition in the Video Programming and Distribution Markets

In the Notice, the Commission requests comments on "relevant economic methodologies that may assist the Commission in its analysis of the extent of competition and market performance in both the markets for multichannel distribution systems and video programming." Notice at ¶ 10. Accordingly, HBO hereby provides the Commission with an economic analytical framework to assist the Commission in analyzing the status of competition in the video programming and distribution markets. HBO's views are set forth in detail in the paper entitled "Economic Methodologies for Evaluating Competition and Performance in Video Programming and Distribution Markets" by Paul L. Joskow, professor of economics and management at MIT (the "Joskow Paper"), attached hereto at Appendix A.

In summary the Joskow Paper posits that:

° Many real world markets do not fit the textbook assumptions of "perfect competition." This is particularly true of video programming and distribution which are characterized by product differentiation, economies of scale, economies of scope, public goods features and a variety of pricing methods. These markets should not be compared to an unachievable perfectly competitive market.

° Potential entry and barriers to entry and expansion should play an important role in the analysis of the vitality of competition and overall performance in video programming and distribution markets. In this regard, the Commission should consider the capacity of competitors to serve the market as well as their actual subscribers and revenues.

° Transaction cost economics can help the Commission evaluate the role of vertical integration and contractual arrangements that encourage investment in new programming and distribution services.

° Comparative institutional analysis evaluates markets in the context of their real life economic and regulatory characteristics and considers the likely market outcome of regulation. The Commission should use this methodology to examine the effect of regulation on consumer welfare and balance the imperfections of regulation against the imperfections of an unregulated or less regulated market. This method essentially asks what is the best marketplace outcome given the regulatory and economic attributes of the market rather than focusing on what might be best in a textbook world that does not exist in reality.

- The Commission should recognize that video programming and distribution are different markets and may have different product and geographic dimensions. In both cases, product markets should not be limited to multichannel programming and distribution; they should include other competing suppliers, such as broadcast and video rentals, in a way that recognizes that they are reasonable but imperfect substitutes and takes direct account of the degree of substitutability.

B. Other Evidence of Competition Among Video Programming Distributors

A number of the comments filed in this proceeding support the conclusion reached by HBO that the video programming industry is increasingly competitive, and all indications are that it will continue to become even more competitive in the near future. For example, Liberty Media Corporation, National Cable Television Association, Inc. ("NCTA"), Satellite Broadcasting and Communications Association of America ("SBCA"), Tele-Communications, Inc. ("TCI"), and Wireless Cable International, Inc. ("Wireless Cable") all demonstrate in their comments that the number of competitors to cable have increased dramatically and that they have no difficulty obtaining the top cable programming.

It is particularly telling that trade associations representing two of the major competitors to cable, Wireless Cable and SBCA, lend support to the view of HBO and others that there now exist numerous viable competitors to cable. For example, Wireless Cable asserted in its comments that "there can no longer be any doubt that wireless cable is providing consumers in many markets with a competitive alternative to their wired cable services provider, and will soon be expanding across the country." Comments of Wireless Cable at 2. In addition, SBCA concluded in its comments that there is "an increasingly competitive trend on the part of the DTH satellite industry" and that this trend is demonstrated by the "greater urban and suburban penetration by DTH than ever before." Comments of SBCA at 20.[2]

C. HBO's Response to Specific Comments Regarding the Competitiveness of the Video Programming Distribution Market

Although the Commission has discouraged commenters from discussing specific business practices in this proceeding, HBO believes it is important to respond to certain of the specific complaints asserted by a few commenters, since those relating to HBO's practices are simply incorrect.[3]

1. Exclusivity Complaints

DirecTv, Inc. ("DirecTv") and National Rural Telecommunications Cooperative ("NRTC") argue in their comments that two specific exclusivity arrangements between HBO and the

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2 With respect to video dialtone, commenters generally agree that it has the potential to become a viable competitor to cable in the near future. See Comments of GTE at 11; Comments of NCTA at 3-4; Comments of TCI at 11.

3 HBO believes that a few specific instances of alleged detrimental behavior cannot justify a conclusion that there is an absence of competition in the video distribution business as a whole.

United States Satellite Broadcasting Co., Inc. ("USSB") and between Viacom and USSB should be voided. However, DirecTv and NRTC fail in their argument that the Commission should find these exclusivity agreements improper under the 1992 Cable Act and the Commission's rules.

First, HBO would like to observe here, as it did in its initial comments, that the issue of USSB exclusivity is well beyond the scope of this proceeding. The Commission has indicated that it wishes to keep this proceeding limited in scope and to avoid issues from other ongoing Commission proceedings that could affect competition. See Notice at ¶ 11.

Moreover, NRTC's assertion in its comments that HBO entered into exclusive DBS programming arrangements with USSB "for the specific purpose of blocking access to Time Warner's programming . . . by NRTC and Hughes at 101°" is simply wrong. In its Ex Parte Response to Ex Parte Presentations of the National Rural Telecommunications Cooperative, HBO demonstrated that it entered into the exclusivity arrangement with USSB for a number of legitimate, pro-competitive business reasons, including the following: (a) USSB indicated to HBO that it was not interested in allocating its limited transponder capacity to HBO programming unless it could obtain limited exclusive rights to distribute HBO in order to differentiate its product offering from DirecTv, which was distributing programming from the same orbital position with significantly greater transponder capacity; (b) USSB, in exchange for this limited exclusivity, expressed a strong desire to aggressively market and promote all of HBO's services; (c) the agreement with USSB provides for multiple distributors of HBO's services, whereas DirecTv wanted NRTC to be the exclusive distributor of HBO programming in the NRTC territories, which was especially undesirable from HBO's perspective since USSB has a distinguished record as a distributor of television programming, whereas NRTC has a very poor record of distributing HBO's services; and (d) USSB agreed to offer multiple feeds of HBO's services, whereas DirecTv only sought to carry one HBO channel.[4]

HBO also explained that the HBO/USSB agreement only provides very limited exclusivity with respect to one single orbital position. It does not give USSB exclusivity against SMATV, C-band satellite distributors, cable operators, nor against MMDS, DBS distributors at other orbital slots, video dialtone providers, or any other distributors. Moreover, consumers who purchase equipment to receive the DirecTv package of programming can also receive the Hubbard programming package without the need for any additional equipment.

In USSB's Ex Parte Response to Ex Parte Presentation by the National Rural Telecommunications Cooperative, USSB showed that DirecTv's inability to offer Time Warner's and Viacom's programming services will not damage DirecTv's competitive posture because DirecTv has a full array of attractive services to offer

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4 Implementation of Sections 12 and 19 of the Cable Television Consumer Protection and Competition Act of 1992, Development of Competition and Diversity in Video Programming Distribution and Carriage, Ex Parte Response Of Home Box Office To Ex Parte Presentation By The National Rural Telecommunications Cooperative, MM Docket No. 92-265, at 10-13 (hereinafter "Program Access Proceeding").

consumers.[5] Moreover, USSB demonstrated that its agreements with Time Warner and Viacom do not violate the Cable Act or the Commission's rules, and are not contrary to the public interest. First, the only exclusive contracts prohibited by the Cable Act are those to which a cable operator is a party; since USSB is not a cable operator, the Cable Act is not implicated by its exclusivity agreements with Time Warner and Viacom. In addition, the USSB exclusivity agreements promote the public interest because they do not deprive the consumer of services, but instead provide service to the entire continental United States, including rural areas.

In light of the foregoing, it is clear that HBO simply made a legitimate business decision to enter into an exclusivity arrangement with USSB, and there is nothing in the Cable Act or Commission rules that would grant DirecTv and NRTC the relief they seek.

2. Rate Complaints

In addition to the complaints as to the USSB exclusivity agreements, one group of joint commenters asserts that there are improper rate differentials between what some programmers charge HSD operators and what they charge cable operators.[6] With respect to HBO, these commenters contend that HBO charges C-Band HSD

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5 Program Access Proceeding, Ex Parte Response To Ex Parte Presentation By The National Rural Telecommunications Cooperative, at 19.

6 Comments of Consumer Satellite Systems, Inc. et al. at 4-5 ("Joint Commenters").

operators 145% more than the highest rate it charges cable operators for the HBO service. In addition, these commenters submit that the rates charged by HBO for Cinemax to C-Band HSD operators were 158% more than the highest rates charged to cable operators.

The rate differentials for HBO services alleged by the Joint Commenters are grossly inaccurate.[7] In any event, the allegations of the Joint Commenters are inappropriate for discussion in this proceeding; the Commission has a complaint process to deal with any alleged instances of discriminatory practices of individual programmers.

II. **FUTURE DATA COLLECTION**

The Commission has asked commenters to suggest specific methods for gathering information, and from whom such information should be obtained, to assist it in preparing accurate and comprehensive annual reports to Congress on the state of competition in the video programming distribution industry. HBO reiterates its position, also recognized by other commenters[8], that the Commission lacks jurisdiction under the 1992 Cable Act to require programmers to file periodic reports, in the absence of allegations that the programmers have violated the program access

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7 A senior executive at HBO discussed the inaccurate figures with counsel for the Joint Commenters. Counsel for the Joint Commenters acknowledged the inaccuracies and stated his intention to correct the record.

8 See e.g., Comments of TCI at 13-15.

provisions. In addition, HBO agrees with many of the other commenters that suggest that a fair amount of the information that the Commission might wish to have is already in the public record.[9] Therefore, the Commission does not need to seek extensive information from cable programmers in order to fulfill its obligation under Section 19(g) of the 1992 Cable Act. However, should the Commission decide that it has jurisdiction to require periodic reporting from programmers and that the information it requires is not in the public record, HBO urges the Commission to adopt procedures designed to obtain the information in a non-burdensome manner that maintains the confidentiality of proprietary business information.

With respect to the specific information the Commission can require from cable programmers, HBO strongly disagrees with those commenters that believe that the Commission's assessment of competition in the delivery of video programming must include the question of damages for a Program Access violation, as well as an analysis of the scope of the Commission's ban against exclusive arrangements.[10] The Commission's report to Congress is simply a factual analysis of the status of competition in the video programming distribution market. It has nothing to do with damages for violations or ultimate determinations with respect to

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9 See e.g., Comments of Liberty Media Corporation at 14-15; Comments of The National Cable Television Association at 29-30; Comments of Tele-Communications, Inc. at 14.

10 See, e.g., Comments of The National Rural Telecommunications Cooperative at n.16.

exclusive programming arrangements. The report to Congress is supposed to discuss what is going on in the market today, and not what the Commission ought to do with respect to specific arrangements or practices.

In addition, HBO disagrees with those commenters that want the Commission to obtain detailed information about the rates charged by programmers to different types of distributors.[11] These commenters are essentially asking the Commission to obtain information sufficient to impose rate regulation upon programmers.

The Cable Act does not give the Commission general rate regulation authority over programmers; it only allows the Commission to deal with specific violations of the Act related to unjustified discrimination. To the extent a multichannel video programming distributor believes discrimination has occurred, it should file a specific complaint with the Commission. There is no justification for the Commission to require information from programmers absent the filing of a complaint, and the commenters urging the Commission to seek detailed information in this proceeding are asking the Commission to exceed its lawful authority in this area. These requests, accordingly, should be denied.

11 See e.g., Joint Comments of Consumer Satellite Systems, Inc. et al. at 6; Comments of the National Rural Telecommunications Cooperative at 26.

III. CONCLUSION

In light of the comments submitted in response to the Notice, HBO submits that the Commission should report to Congress that the state of competition in the video programming distribution industry is healthy and increasingly vigorous, and that there is no need for further regulation at this time.

Respectfully submitted,

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July 29, 1994

ATTACHMENT A

n/e/r/a
National Economic Research Associates, Inc.
Consulting Economists

ECONOMIC METHODOLOGIES FOR EVALUATING COMPETITION AND PERFORMANCE IN VIDEO PROGRAMMING AND DISTRIBUTION MARKETS

By

Paul L. Joskow[1]

I have been asked by Home Box Office to respond to the Commission's questions regarding the relevant economic methodologies that may assist the Commission in the evaluation of competition and market performance in the video programming and distribution markets.[2] The Commission solicits comments on three specific economic methodologies: (1) standard structure-conduct-performance analysis and complementary antitrust concepts; (2) contestable market theory with its emphasis on entry barriers, especially sunk costs; and (3) transaction cost economics with its emphasis on the specific characteristics of business transactions. In addition, the Commission requests comments on any other relevant methodologies. I will comment on each of the three economic methods and suggest a fourth: a comparative institutional analysis. This fourth methodology compares the performance of different feasible market outcomes and considers the effects of regulation on long run economic welfare.[3]

I have also been asked to respond to questions regarding market definition from a methodological perspective.[4]

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[1] Mitsui Professor of Economics and Management at the Massachusetts Institute of Technology and Special Consultant to National Economic Research Associates.

[2] *Notice of Inquiry*, CS Docket No. 94-48 at 5.

[3] See, for example, Paul L. Joskow and Nancy L. Rose, "The Effects of Economic Regulation," in *Handbook of Industrial Organization*, R. Schmalensee and R. Willig, eds., (Amsterdam: North-Holland, 1989), Chapter 25.

[4] *Notice of Inquiry* at 7.

I. ECONOMIC METHODOLOGIES

The Commission should not assume that the three methodological approaches it cited are mutually exclusive. Research from each of these perspectives plays an important role in modern industrial organization and developments in each area are frequently interdependent. A good understanding of the relationships between basic economic conditions, market structure, firm behavior and market performance is the fundamental framework that guides all research in the area of industrial organization and the application of industrial organization principles to regulatory and antitrust policy questions.[5] Entry conditions, barriers to entry and sunk costs have played an important role in understanding these relationships for many years.[6] More recent research focusing on both contestable markets and strategic entry deterrence has deepened this understanding.[7] Similarly, transaction cost economics, and more broadly work on incomplete contracts and principal-agent problems, has played an important role for some time in understanding why firms are organized in particular ways and why "nonstandard" contracts emerge in certain circumstances.[8]

Thus, at the outset, I suggest that the Commission avoid adopting a particular narrow and rigid methodological framework for evaluating competition and market performance. Instead, it should properly apply all the relevant tools of modern industrial organization to the economic attributes that characterize the video programming and distribution markets.

A. Standard Structure-Conduct-Performance Analysis

Structure-conduct-performance (SCP) analysis has played an important role in the development and evolution of antitrust policy during the post World War II period. At one level, the

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5 See *Handbook of Industrial Organization* for a good modern survey of the field of industrial organization.

6 Bain's classic volume was published almost forty years ago. Joe S. Bain, *Barriers to New Competition*, (Cambridge, MA: Harvard University Press, 1956).

7 *Handbook of Industrial Organization*, Chapters 6, 8, and 9.

8 Ronald Coase, "The Nature of the Firm," *Economica* 4 n.s. (November 1937), 386-405 and Oliver E. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications*, (New York: Free Press, 1975) and *The Economic Institutions of Capitalism: Firms, Market Relational Contracting*, (New York: Free Press, 1985).

SCP framework is synonymous with the broad field of industrial organization as it exists today.[9] However, the SCP paradigm is also more narrowly associated with an empirical tradition that dominated industrial organization until the late 1970s.[10] This tradition focused on simple empirical relationships between measures of market structure (primarily seller concentration) and performance (primarily measures of static price/cost margins and profitability).

The old SCP paradigm has serious theoretical and empirical deficiencies. It lacks a strong foundation in microeconomic theory and relies on results obtained by empirical methods that are no longer widely accepted.[11] Modern industrial organization uses a much richer set of theoretical tools[12] and improved empirical techniques that focus on the attributes of specific firms and markets.[13]

Old SCP analysis assumed that most industries could approximate a textbook model of perfect competition, with many small firms producing homogeneous products.[14] Its proponents argued that production technology in most markets is not characterized by economies of scale or scope and that product differentiation was motivated primarily by a desire to enhance market power without countervailing consumer benefits. Empirical work focused almost exclusively on manufacturing industries and relatively homogeneous products. Modern industrial organization accepts the fact that markets are much more complicated and diverse. It recognizes that the perfect competition model does not fit the underlying characteristics of many real world products.

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[9] See Dennis W. Carlton and Jeffrey M. Perloff, *Modern Industrial Organization*, (New York: Harper Collins, 1994) and Jean Tirole, *The Theory of Industrial Organization*, (Cambridge, MA: The MIT Press, 1988).

[10] The *Notice of Inquiry* cites Scherer and Ross's text for a discussion of the SCP methodology. This book describes SCP analysis in the earlier, narrow sense. Much of the theoretical and empirical work it contains is dated.

[11] Tirole, *The Theory of Industrial Organization*, pp. 1-3 and Richard Schmalensee, "Inter-Industry Studies of Structure and Performance," *Handbook of Industrial Organization*, Chapter 16.

[12] See, for example, Tirole, *The Theory of Industrial Organization*, and *Handbook of Industrial Organization*, Volume I.

[13] Timothy F. Bresnahan, "Empirical Studies of Industries with Market Power," *Handbook of Industrial Organization*, Chapter 17.

[14] Of even more concern, from the perspective of evaluating market performance and alternative public policies, work in this tradition assumed that antitrust policies could operate at little cost and without error to force "imperfect" markets to look like and perform like textbook perfectly competitive markets. The need to assess the effect of regulation on market performance is discussed in Section I.D. below.

The old SCP framework measured market performance primarily by short run profitability. Its empirical work was most successful in examining static cost and pricing relationships for homogeneous products and least successful in explaining product and process innovation and related dynamic characteristics.[15] Modern industrial organization no longer focuses on purely static welfare goals. It acknowledges that welfare losses from discouraging new products and services can be much larger than welfare gains from regulating prices to bring them closer to marginal cost.[16]

These deficiencies of the old SCP paradigm make it particularly unsuitable for evaluating competition and market performance in the video programming and distribution markets. Video programming and distribution are not homogenous products. For example, each programming service has unique features. This product differentiation is not merely a characteristic of the existing programming services, but a necessary and desirable feature.[17] Video services also have other characteristics that do not fit well within the SCP paradigm, including economies of scale and scope, public goods attributes and associated free rider problems, and a variety of nonstandard pricing methods (e.g., both advertising and monthly subscriptions). The SCP price-cost performance measure cannot be applied meaningfully to products with these inherent features. For example, market prices are equal to marginal cost in a textbook model of perfect competition. However, the video markets at issue here are generally characterized by high fixed costs and low marginal costs. That is, there are high costs of putting a programming service or distribution system in place and low costs of adding subscribers. If each subscriber were charged a price equal only to his marginal cost, there would be no revenue to cover the fixed costs. Such pricing would ensure that private for-profit firms would not supply these services. As a result, a finding that price is different from marginal cost in

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15 A direct consequence of this old SCP perspective was the view that relevant product and geographic markets could be easily defined, i.e., that some products were clearly in the market and others clearly out. Moreover, computations of seller market shares and concentration ratios in the relevant market were often substituted for a careful and complete empirical analysis of firm behavior and market performance in specific market environments. Such "concentration ratio fixation" is likely to be particularly troublesome when it is applied to narrowly defined, differentiated product markets. There are typically few direct competitors occupying the same niche of a differentiated product market. Defining a market to include only very close substitutes and relying on concentration ratios in that market to assess competition can make very competitive markets appear noncompetitive. These issues are discussed in Section II.

16 For a discussion of issues associated with measuring the value of new goods and services see Jerry A. Hausman, "Valuation of New Goods Under Perfect and Imperfect Competition," MIT Economics Department Working Paper, Number 94-21, (June 1994).

17 The first statement of policy in the 1992 Cable Act calls for the promotion of "a diversity of views and information."

these markets tells us nothing particularly useful about market performance or how public policy can improve it.

Further, video programming and distribution are dynamic markets and the 1992 Cable Act includes dynamic goals, particularly expansion of programming offered by cable operators. Thus, analytical approaches and empirical results drawn from the SCP literature are unlikely to be useful for evaluating competition and performance in these markets.

B. Contestable Market Theory

The role of entry and exit barriers and sunk costs, subjects that are much broader than contestable market theory, can play an important role in the analysis of competition and market performance. However, contestable market theory itself is likely to be of limited value in analyzing video programming and distribution markets. Stripped to its core, contestable market theory looks at a particular entry condition: when new suppliers can enter a market quickly and easily without having to make investments that cannot be freely redeployed to other markets (i.e., they incur no sunk costs). Given this and other conditions, even if there is only a single incumbent supplier in the market, the threat of "hit and run" entry will force this "monopoly" to charge prices which, on average, do not exceed its total economic costs of production. In this case, the market share of an incumbent supplier provides no useful information about market power. Indeed, if there are economies of scale, a single supplier would be the efficient solution and this supplier would be unable to exercise meaningful market power.

The results associated with contestable market theory generally depend on very strong assumptions about the characteristics of investments, behavioral responses of incumbents, information and transactions costs. It is hard to find markets where all of the relevant assumptions are likely to be valid. The strong assumptions that underlie much of contestable market theory have led some to conclude that it is not useful and, more importantly, that the role of entry barriers, sunk costs, and the effects of potential entry can be ignored. This conclusion is in error. Potential entry, entry barriers and sunk costs have long been recognized as having significant implications for market structure and market performance. This view continues in modern industrial organization even as contestable market theory is seen as having limited usefulness.[18]

The entry and growth of new suppliers in the market should play an important role in the analysis of the vitality of competition in video programming and distribution markets. Many of the

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[18] See Tirole, *The Theory of Industrial Organization*, Chapter 8.

regulations imposed by the Commission as a consequence of the Cable Act of 1992 were motivated by the perception that a substantial barrier to entry at the program distribution level was the lack of availability of high quality programming to new entrants, especially regarding programming that was partially owned by cable system operators (vertical integration). This suggests that the ability of new entrants to obtain programming on reasonable terms and conditions is especially relevant with regard to the regulations governing vertical integration and the behavior of entities that own both program distributors and programming services. So too are the effects of the Commission's regulations on the availability of space on distribution systems for new programs and on the development of new programs and services.

In its evaluations of market competition and performance, the Commission should not focus simply on the number of competitors. Adopting regulations that are aimed at increasing the number of competitors *per se* can reduce rather than enhance market performance. For example, inefficient distributors may only be able to survive under an umbrella of unnecessarily high subscriber prices. As another example, regulations requiring that programmers provide services to all new distributors may inhibit investments in new programming by existing distributors or, in the case of new technologies, inhibit investment by distributors that are unable to differentiate their products. Thus, the Commission should not judge the performance of the market simply by counting the number of entrants or by assuming that exclusivity arrangements are inherently undesirable; rather, it should evaluate the overall performance of the market, including costs, prices and satisfaction of consumer preferences as well as entry.

Furthermore, once new suppliers do enter the relevant markets and incur sunk costs in doing so, their presence in the market may have a much larger effect on competition in the long run than might otherwise be implied by looking only at their share of subscribers soon after entry. This is especially true if the entrants can quickly expand the availability of their services to additional subscribers at low marginal cost. Ease of expansion by market participants with relatively few current subscribers can be an important constraint on the behavior of those with more subscribers. For example, given today's prices and relative quality, most subscribers in an area may prefer one particular multichannel distributor, but if that distributor were to raise prices or reduce quality, smaller distributors with the capacity to serve that area could easily serve the dissatisfied subscribers. Thus, to the extent that the Commission looks at market shares in assessing competition, it should consider shares based on the *capacity* to serve the market rather than looking only at subscriber or revenue shares.

C. Transactions Cost Theory

Transaction cost theory, the theoretical and empirical analyses generally associated with the work of Ronald Coase and more importantly Oliver Williamson, is particularly useful in analyzing video programming and distribution markets. I would expand this methodological framework to include associated theoretical and empirical work related to incomplete contracts and principal-agent problems.[19] These methodological perspectives can be especially useful for understanding many of the issues associated with vertical integration and nonstandard contracting that have arisen in video markets. They are an important counterweight to the erroneous implicit assumptions embodied in the old SCP paradigm that such arrangements were inherently suspect and indicative of monopoly power or intent.

Transaction cost economics has played too little a role in the Commission's consideration of video programming and distribution markets and particularly of the tradeoffs that may exist between the competitive effects of vertical arrangements and their effects on consumer welfare.[20] Recent research in transactions cost economics suggests that products with attributes like those of video programming and distribution are often supported by governance structures involving vertical integration and "restrictive" vertical arrangements to allow investors to capture the benefits of their efforts. Transactions cost economics can be very useful for understanding why these organizational and contractual arrangements emerge. They are not necessarily anticompetitive and can enhance consumer welfare by helping to bring new products and services to market.

The transaction cost economics perspective can also help the Commission to evaluate the effects of alternative regulatory strategies for fulfilling its responsibilities under the Cable Act. At the time the Cable Act was passed, cable programmers and distributors had many contractual relationships in place. These relationships reflected the assessment of and expectations about current and future economic and regulatory conditions at the time the contracts were executed. One or both parties to the contractual relationship may have made specific sunk investments in reliance on the credibility of

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[19] See, for example, Bengt R. Holmstrom and Jean Tirole, "The Theory of the Firm," *Handbook of Industrial Organization*, Chapter 2; and Oliver Hart and Bengt R. Holmstrom, "The Theory of Contracts," in *Advances in Economic Theory, Fifth World Congress*, Truman Bewley, ed., (New York: Cambridge University Press, 1987).

[20] The need to understand and evaluate such tradeoffs is discussed in Paul L. Joskow, "The Role of Transactions Cost Economics in Antitrust and Public Utility Regulatory Policies," *Journal of Law, Economics and Organization* 7, (1991): 53-83 .

these commitments.[21] As economic conditions change, the mutual desirability of the terms and conditions of these contractual relationships are likely to change as well. Empirical research shows that the nature of contractual arrangements between buyers and sellers can vary widely over time as conditions change.[22] Efficient transactions require the ability of contracting parties both to rely on the credibility of their contractual bargains and to negotiate new contractual arrangements that reflect current rather than past economic conditions. As a result, the Commission should exercise extreme caution in adopting regulations that will facilitate breaches of existing contracts or impose requirements on suppliers to offer contracts today with similar terms and conditions to those negotiated in the past.

D. Comparative Institutional Analysis

Modern industrial organization theory addresses competition, market power, market performance, and antitrust and regulatory policies with comparative institutional analysis in which the performance attributes of different feasible market outcomes are compared to one another rather than to an unachievable textbook model. This analysis has several features that would be beneficial in assessing competition and market performance in video programming and distribution markets.

1. It evaluates markets in the context of their basic economic characteristics. As noted above, video services are differentiated from one another. Their supply and distribution are also characterized by economies of scale and scope and certain public goods features. They must rely on a variety of pricing methods to make it possible to charge viewers for services and to exclude free riders. These characteristics do not fit a standard textbook model of perfect competition. As a result, a useful measure of competition and performance in these markets should compare the current status to other feasible outcomes. Further, the markets themselves should not be limited to multichannel programming and distribution, but should include all competing (substitute) suppliers, taking direct account of the extent of their substitution characteristics.[23]

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[21] See, for example, Paul L. Joskow, "Contract Duration and Relationship Specific Investments: Empirical Evidence from Coal Markets," *American Economic Review* 77, (March 1987): 168-185.

[22] See, for example, Paul L. Joskow, "Price Adjustment in Long-Term Contracts: The Case of Coal," *Journal of Law and Economics* 31, 1, (April 1988): 47-83; and Paul L. Joskow "The Performance of Long-Term Contracts: Further Evidence From Coal Markets," *Rand Journal of Economics* 21, 2, (Summer 1990): 251-274.

[23] This is discussed more fully in Section II below.